U.S. Small Business Administration
Your Small Business Resource

UNITED STATES GOVERNMENT
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How to Seek Venture Capital, Debt Equity or Find Angel Investors

By Bruce Hodgman, Deputy Director

One key attribute to be a successful entrepreneur is the ability to obtain and secure appropriate financing. Raising capital is the most basic of all business activities, but critical in new business start-ups or businesses going to the next level. Remember, it takes money to make more money.

Flip open many trade publications and business newspapers and you will be bombarded by reports of abundance of available capital for entrepreneurial start-ups, particularly for the dot coms. The financial news would have you believe that more money is available for new business ventures than there are good business ideas.

However, while venture capital may be overflowing for the high-tech or bio-medicine industries, the real scenario for small businesses (and worse, home-based businesses) is far different. Capital is hard to come-by, especially if: (a) you do not have a good business idea or business plan that will make investors run to you in the hope of multiplying their investment exponentially; and (b) you may have a good business idea, but you do not know anyone who matters or has money to invest. The problem is that entrepreneurs seeking private investment do not know what to believe or which way to turn for help.

Then again, business means risk, and success comes to those who focus on their goals and actually do something. You first step should be to start making phone calls -- talking to people, and making appointments to discuss your plans with the people who have money to invest. When you're looking for money, it's essential that you get the word out to as many potential investors as possible. Find out what is available as there are several sources to consider when looking for equity financing. Explore all of your options before making a decision of which source to pursue.

<u>"Angel" or Private Investors.</u>

The term "angel investor" conjures up a vision of some kind of saintly benefactor with money falling out of his pockets and willing to invest on some whimsical notion of a business that has little chance of success. Nothing could be further from the truth. These people invest for the same reason other people do -- to make money. They hope that some of their investments will reap them high rewards in return for the high risks they will take by investing in YOUR business.

Angel investors are typically high net-worth individuals who generally prefer to invest in small businesses, usually at an early stage. Like a traditional venture capital firm, many angel investors provide cash to young companies and take equity or an ownership position in return for their investment. One difference is that angel investors typically invest <u>smaller amounts</u> of money in individual companies than venture capitalists do, making them a possible resource for many that have exhausted their "friends and family" financing options but are not ready to approach the traditional venture funds for capital.

Angels are interested in making more on their capital than they can make through traditional markets such as mutual funds or publicly traded stocks. These investors can be your local accountant, attorney, doctor or other individual that is seeking out new businesses to invest in return for equity ownership. They usually provide capital in the range of $25,000 to $500,000, and you should expect them to demand high returns for their investments. Relative to venture capitalists, angel investors are less demanding and can also be expected to provide expert guidance and mentoring for entrepreneurs in the process of developing a start-up business. They will want to take an active part as very few are "passive" investors. Please note that negotiating the terms of a deal with an angel will always be tricky, and disagreements about operations can be difficult to hash out.

According to the Center for Venture Research, most angel investors prefer "staying under the radar as this allows them to pick and choose their sources for their quality deal flow. People find them anyway, but the harder to find them, the better." Private angels, like any investment source, like businesses that appear likely to grow at 30% to 40% annually and then be bought or go public after 4 to 7 years. I would recommend that you show them a plan that features a way for them to make a profitable exit or they will not be interested. This is the Number One reason most entrepreneurs fail with an angel investor -- lack of exit strategy.

Finding private investors can be difficult, especially in smaller markets. That's because individual angels generally like it that way, if only because they aren't terribly interested in having thousands of Arizona entrepreneurs flood their e-mail boxes with business plans or getting phone calls in the wee hours on the weekends.

Many entrepreneurs seeking angels use advertising along with cold-calls or canvassing to find their capital source. As simple as it seems, many have raised money by advertising in a newspaper of a regional or national publication featuring such ads. Your ad should state the amount of money you want, type of business involved (to separate the curious from the truly interested), and the kind of return you are promising on the investment along with a successful exit strategy. On the Internet, several web sites offer match-up services for investors and capital seekers. Contact local business groups or Chambers of Commerce for possible leads.

Angel Groups.

Angel investors are forming investment groups usually in the $100,000 to $ 1 million range. Their primary purpose is to become more visible to people with ideas. These groups are generally local organizations made up of 10 to 50 accredited investors interested in early-stage investing, often by either pooling their investment to reduce risk or as individuals. How angel groups operate vary greatly by area and focus. Many have websites that contain templates for entrepreneurs to fill out. Usually a staff or screening committee will select a group of businesses for further investigation, and out of that bunch a few will be invited to present before the entire angel group. Generally, individual members make their own investment decisions after the presentation and other groups operate with a fund that is the primary investment vehicle. The best place to research angel groups is the web. Note that individual investors still represent the bulk of activity.

Venture Capitalists or VC's.

If you are seeking a larger investment, say above $1.5 million than you may want to consider a Venture Capitalist. These money experts are professional investors or companies that are usually in charge of a large pool of capital gathered from a range of different investing sources. These firms invest in new, even high-risk or speculative businesses without a proven track record, but with the potential for rapid growth and high returns in a very short time. They generally want equity or part ownership of a business in exchange for substantial returns (25 to 40 percent or more) when they exit typically in three to seven years.

Particularly in the Internet sector, several venture capital firms have achieved capital gains of 300 to 500 percent, which are used to offset by a wide margin any losing ventures. These firms are mostly interested in potential projects that require $5,000,000 or more because of the high cost of investigation, evaluation and administration. While a venture capital firm may receive as many as 1,000 business proposals a year, it will typically investigate less than 10 percent and may actually invest in only 3 or 4 percent.

Small Business Investment Companies.

Small business investment companies (SBIC's) exist to supply equity capital, long-term loans and management assistance to qualifying small businesses. The privately owned and operated SBIC's use their own capital and funds borrowed from the U.S. Small Business Administration (SBA) to provide financing to small businesses in the form of equity securities and long-term loans. SBIC's are profit-seeking organizations that select small businesses to be financed within rules and regulations set by SBA.

SBIC's invest in a broad range of industries. Some SBIC's seek out small businesses with new products or services because of the strong growth potential of such firms while other SBIC's specialize in the field in which their management has special competency. Most SBIC's, however, consider a variety of investment opportunities.

Only firms defined by SBA as small are eligible for SBIC financing. The SBA defines a company as small when its net worth is $18.0 million or less, and its average net (after tax) income for the preceding two years does not exceed $6.0 million. For businesses in industries for which the above standards are too low, alternative size standards are available. In determining whether a business qualifies, all of the business's parents, subsidiaries and affiliates are considered.

Approaching an SBIC

If you own or operate a small business and would like to obtain SBIC financing, you should first identify and investigate existing SBIC's that may be interested in financing your company. Use this brochure as a first step in learning as much as possible about SBIC's or other areas that are important to your company's success. A listing of all SBIC's nationally can be found at **http://www.sba.gov/INV/opersbic.html,** In choosing an SBIC, consider the types of investments it makes, how much money is available for investment and how much might be available in the future. You should also consider whether the SBIC could offer you management services appropriate to your needs.

- ☑ Plan in Advance. You should determine your company's needs and research SBIC's well in advance long before you will actually need the money. Your research will take time, as will the SBIC's research of your business.

- ☑ Prepare a Prospectus/Business Plan. When you've identified the SBIC you think is best suited to provide financing for your company, you'll need to prepare a presentation. Your initial presentation will play a major role in your success in obtaining financing. It is up to you to demonstrate that an investment in your firm is worthwhile and you have a sound exit strategy. The best way to show worth is by presenting a *detailed and comprehensive business plan or prospectus.* The minimum information required for a successful business plan can be found on SBA's web page: **http://www.sba.gov/smallbusinessplanner/plan/writeabusinessplan/index.html**

If you need no-cost assistance in preparing a business plan, please call (602) 745-7200 and ask for information about SBA's *Small Business Development Centers (SBDC's)* or *SCORE Chapters.* The SBA and our resource partners can be found at **http://www.sba.gov/localresources/district/az/counselingt/index.html.**

The SBIC Program is one of many financial assistance programs available from the SBA. The structure of the program is unique in that SBICs are privately owned and managed investment funds, licensed and regulated by SBA, that use their own capital plus funds borrowed with an SBA guarantee to make equity and debt investments in qualifying small businesses. The U.S. Small Business Administration does not invest directly into small business through the SBIC Program. If you are interested in forming and managing an SBIC fund, please see **www.sba.gov/INV/forsbicapp.html.**

We encourage you to review the information below to better understand the program and process for accessing SBIC capital. As you review the information, keep in mind that SBIC financing is not appropriate for all types of businesses and financing needs. The SBA offers a wide variety of financial assistance programs designed to suit the varied needs of America's small businesses. To learn more about other financing options available through the SBA, refer to the website at **www.sba.gov** or call 1-800-UASK-SBA (1-800-827-5722).

Seeking SBIC Financing.

Only companies defined by SBA as "small" are eligible for SBIC financing. Generally, the SBIC Program defines a company as "small" when its net worth is $18.0 million or less and its average after tax net income for the prior two years does not exceed $6.0 million. All of the company's subsidiaries, parent companies and affiliates are considered in determining the size standard and for certain industries alternative size standards may apply. Detail regarding regulatory size limitations is included in **www.sba.gov/library/cfrs/13cfr121.pdf.**

SBICs may not invest in the following: other SBICs, finance and investment companies or finance-type leasing companies, unimproved real estate, companies with less than 51% of their assets and employees in the United States, passive or casual businesses (those not engaged in a regular and continuous business operation), or companies which will use the proceeds to acquire farm land. SBICs may not provide funds for a small concern whose primary business activity is deemed contrary to the public interest.

Resources.

There are extensive educational resources available to entrepreneurs that want to evaluate different risk capital options and what type may best fit their financing needs. Be sure to review this document, the resource links below and our web site at www.sba.gov/inv. After you have taken time to familiarize yourself with the SBIC Program, venture capital, mezzanine lending and private or angel equity, if you believe your business would be a good fit for SBIC financing, you should first research and identify existing SBICs that may be interested in financing your company. In choosing an SBIC, consider the type of investments it makes, stage of investments, industry focus and geographic concentration.

Final Thoughts…

- ☑ GOLDEN RULE OF INVESTING -- Make sure you carefully research the source of funds and what is expected of you. Get professional assistance, such as legal or accounting, before you make your final decision.
- ☑ Consider the idea of inviting investors to share in your business as silent partners.
- ☑ Think about the concept of obtaining financing for a primary business by arranging financing for another business that will support the start-up, establishment and development of the primary business.
- ☑ Consider the feasibility of merging with a company that's already organized, and with facilities that are compatible or related to your needs.
- ☑ Give some thought to the possibilities of getting the people supplying your product or production equipment to co-sign the loan you need for start-up capital. This is truly the age of creative financing.

The truth is this: Now is the time to make your move. Now is the time to act. The person with a truly viable, professional business plan and the determination to succeed will make use of every possible idea that can be imagined. And the ideas I've suggested here should serve as just a few of the unlimited sources of monetary help available and waiting for you!

Good luck!

Bruce Hodgman
Small Business Administration

SBIC Licensees Located in Arizona.

Magnet Capital, L.P. Contact: G. Mischel or M. Shields 3550 North Central Ave., Suite 1400 Phoenix, AZ 85012 Phone: 602. 222. 4801 Fax Number: 602. 222. 4807 Email: info@magnetcapital.com Web: magnetcapital.com INVESTMENT CRITERIA: *Loans, Mezzanine Financing & Equity* INVESTMENT SIZE RANGE: **$250,000 to $1,500,000** TYPE OF CAPITAL PROVIDED: *Expansion and Acquisition* FUNDING STAGE PREFERENCE: *Growth* INDUSTRIES: *Manufacturing, Wholesale, and Service* GEOGRAPHIC PREFERENCES: *Southwestern USA* DESCRIPTION OF FIRM'S FOCUS: *Open to all areas*	**Grayhawk Venture Fund I, L.P.** Contact: Sherman Chu 5050 North 40th Street, Suite 310 Phoenix, AZ 85018 Phone: 602. 956.8700 Fax: 602.956.8080 Email: schu@gvp.us Web: www.gvp.us INVESTMENT CRITERIA: *Equity (minority ownership)* INVESTMENT SIZE RANGE: **$500,000 to $4,000,000** TYPE OF CAPITAL PROVIDED: *Expansion and Growth* FUNDING STAGE PREFERENCE: *Early stage, growth and special situations* INDUSTRIES: *Technology, Internet, Telecommunications, Financial Services, Healthcare, Distribution, and Manufacturing.* GEOGRAPHIC PREFERENCE: *Southwestern USA* DESCRIPTION OF FIRM'S FOCUS: *Investments that invest in companies with strong business momentum that operate in growth industries (or in industries in the early stage of consolidation), and are led by operations-oriented executives.*

TYPICAL SOURCES OF CAPITAL FOR SMALL BUSINESSES